IN THE HIGH COURT OF PUNJAB AND HARYANA AT CHANDIGARH

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I.T.R. No.37 of 1991
Date of Decision:16.05.2007

The Commissioner of Income-tax, Patiala

.....Petitioner

Vs.

M/s S.A.Builders Pvt. Ltd., Chandigarh

.....Respondent

CORAM:- HON'BLE MR. JUSTICE M.M.KUMAR
HON'BLE MR. JUSTICE RAJESH BINDAL

Present:- Mr. S.K.Garg Narwana, Advocate for the revenue.

Mr. Akshay Bhan, Advocate for the assessee.

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RAJESH BINDAL, J.

The following question of law has been referred for opinion of this Court arising out of order dated 9.9.1988 passed by the Income-Tax Appellate Tribunal, Chandigarh Bench, Chandigarh (for short, `the Tribunal') in I.T.A. No.493/Chandi/87 for the assessment year 1983-84:-

> "Whether, on the facts and in the circumstances of the case, the Appellate Tribunal was right in law in holding that forfeiture of security deposits amounting to Rs.16.27 lakhs by way of compensation for not completing the contract works within the stipulated period specified in the agreement, constituted an allowable commercial loss, notwithstanding the fact that the matter is pending disposal before the Arbitrator?"

Briefly, the facts are that the assessee in the present case is a contractor executing various works. While computing the income for the assessment year in question, the assessee claimed a deduction of Rs.16.27 lakhs on account of compensation paid to the contractee for delay in execution of the works. The claim was rejected by the Assessing Officer. However, in appeal, the Commissioner of Income Tax (Appeals) (for short, `the CIT(A)') while relying upon a judgment of Hon'ble the Supreme Court in **Commissioner of Income-Tax, Central, Calcutta and another v.**

Amalgamated Development Ltd., (1967) 65 ITR 395 held that the amount in question, being only on account of compensation for breach of contract and not a penalty for breach of law, was allowable. In further appeal by the revenue, the Tribunal upheld the order passed by the CIT(A) while relying upon an earlier order passed by it in the case of Punjab Wireless Systems Limited. It was observed by the Tribunal that the amount in question had already been forfeited by the contractee by invoking the bank guarantees furnished by the assessee.

We have heard learned counsel for the parties and with their assistance perused the paper book.

The only contention raised by learned counsel for the revenue is that the penalty of any kind suffered by the assessee on account of default in execution of contract cannot be allowed as a business expense and the Assessing Officer was right in disallowing the claim made by the assessee on that account. To buttress the submission, he relied upon a judgment of this Court in **Cineramas v. Commissioner of Income-Tax, Amritsar-I,** (1977) 110 ITR 762. On the contrary, learned counsel appearing for the assessee submitted that there is distinction culled out by various judicial pronouncements in penalty leviable for breach of law and penalty/ compensation arising out of the breach of contract. Whereas the penalty leviable on account of breach of law is not a permissible deduction, however, penalty which is on account of breach of contract is certainly a business loss and has to be allowed. He referred to **Commissioner of Income-Tax v. Murari Lal Ahuja and Sons,** (1989) 177 ITR 228 (P&H), **Prakash Cotton Mills P. Ltd. v. Commissioner of Income-Tax,** (1993) 201 ITR 684 (SC) and **Commissioner of Income-Tax v. Indo Asian Switch-Gears (P.) Ltd.,** (1996) 222 ITR 772 (P&H).

While considering a similar issue, Hon'ble the Supreme Court in **Prakash Cotton Mills' case (supra)** held that deduction is to be allowed where the amount is wholly compensatory in nature and where the amount is composite which contains elements of compensation and penalty then it is only the compensatory part which is allowable as a deduction and not the penal part. This Court in **Murari Lal Ahuja's case (supra)** held that where an assessee, engaged in the business of sale of cotton, having failed to fulfil the contract for supply of cotton to certain mills, settled the deal by

paying a sum as compensation, the amount of compensation paid by the assessee was held to be an allowable deduction. Similar view was expressed by a Division Bench of this Court in **Indo Asian Switch-Gears' case (supra)** where the amount of penalty paid by the assessee therein to Punjab State Electricity Board on account of late delivery of goods was held not to be on account of infringement of law but breach of a contractual obligation and, accordingly, deductible as business expense.

The issue for consideration before this Court in **Cineramas' case (supra)** was allowability of deduction on account of breach of law and not breach of contractual obligation which forms a class apart. Accordingly, the judgment in **Cineramas' case (supra)** is distinguishable and will not be applicable to the facts and circumstances of the present case.

It is also not disputed by learned counsel for the revenue that the reference arising out of Punjab Wireless Systems' case (supra), which was relied upon by the Tribunal, in favour of the assessee, has been answered by this Court against the revenue.

In the present case, the compensation paid by the assessee was on account of breach of contract which does not fall in the category of payment of penalty for breach of any law but would be a compensation for breach of contractual obligations, accordingly, will fall in the category of allowable deduction.

For the reasons recorded above, the question referred is answered against the revenue and in favour of the assessee.

The reference is disposed of accordingly.

(RAJESH BINDAL)
JUDGE

May 16, 2007 **(M.M.KUMAR)**
renu **JUDGE**